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'In Perspective©' -- The Oxford Analytica Weekly Column

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November 14, 2001: INTERNATIONAL -- IMF Crisis Decisions

The IMF's major shareholders have shown little willingness to provide new funds to Argentina. In deferring further assistance, the United States and other G7 shareholders have set limits on the international financial community's role in resolving a major emerging market financial crisis. The slowing global economy could provide an early test of these limits as it exposes weaknesses in other emerging markets -- particularly those with larger geopolitical profiles than Argentina.

Argentina's predicament highlights the Fund's paradox in wanting, on the one hand, to facilitate orderly resolution of crises (and prevent calamitous social impacts) and, on the other hand, to encourage markets to appropriately price risk by proving that non-optimal outcomes are possible. The risk of such outcomes is the basis upon which investors demand higher premiums from emerging market borrowers.

The United States and the other major shareholders in the IMF released a statement on November 2 welcoming Argentina's measures to reduce the cost of its debt but offered no international assistance to reassure markets that Argentina will be able to meet the original terms of its debt obligations. Argentine President Fernando de la Rua's meeting with US President George Bush on November 11 also failed to secure pledges of financial support for Argentina. In communicating their reluctance to arrange additional financing but willingness to have the IMF play a role in formulating a strategy to return Argentina to economic growth, the major shareholders in the IMF have set a boundary for official involvement and signalled that private creditors will realise some portion of the risk priced into emerging market assets.

Argentina benchmark. The shareholders' decision comes at a potentially critical juncture for the IMF, as the worldwide economic downturn has the potential to become the worst global recession in the post-war period. As the downturn exposes weaknesses in a broadening array of emerging markets, the Fund and the United States are likely to be in the position of weighing the geopolitical salience of certain weak markets against the benchmark established by their approach to Argentina.

In deciding whether to extend additional financing to Argentina, IMF and G7 policymakers had to consider the likelihood that Argentina would eventually be able to generate economic growth adequate to meet its debt obligations and fulfil domestic financing requirements. In economic terms, the question is whether the economy's growth rate can match or exceed the growth rate of public debt. For a variety of reasons -- many out of Argentina's control -- the answer is negative, which makes the debt unsustainable since it will 'explode' relative to GDP (which proxies for a country's resource base from which to repay debt). The resulting conclusion holds that committing additional international financing to this unsustainable debt dynamic constitutes a violation of the temporary 'liquidity crisis' nature of the Fund's interventions in the international financial system.

In deciding not to facilitate Argentina's explosive debt dynamic, the IMF and its principal shareholders could bear other costs. One of these is credibility, in the sense that the IMF will be severely blamed should one or both of the following outcomes materialise:

- Reorganisation of Argentina's debt is chaotic and results in comprehensive loss of access to private capital flows, including the ability to facilitate critical international commercial transactions. Lacking international intervention, authorities impose heterodox solutions (eg capital controls), thus moving the world further from the ideal of open capital markets.

- Chaotic debt reorganisation triggers precipitous movements in other emerging market assets -- so-called 'contagion', forcing the international community to increase financial intervention to prevent or contain crises in geopolitically important but economically weak emerging markets.

  Depending upon the scenario actually realised, the Fund could be criticised for letting a once-promising exponent of the 'Washington consensus' implode (or adopt heterodoxy) and/or for failing to meet its role of stabilising the international financial system. Criticism will be levelled despite the fact that the Fund's precise role remains ambiguous. Reforms, whether enumerated in the Meltzer Commission report or, more recently, in advice to turn the IMF into a 'lender of last resort', continue to be debated between the Fund, its shareholders, academics and non-governmental observers.

The Fund's decision could also come in for criticism given its ongoing assistance to countries with inferior fundamentals, particularly in static terms such as external debt as a percentage of GDP. Argentina's 155 billion dollar national and provincial debt represents a smaller portion of GDP (58%) than that of several other developing countries in Fund programmes.

Geopolitics. A more serious measure of the Fund's credibility could come if the Fund confronts a balance of payments crisis on a par with (or indeed more severe than) Argentina's, but in an emerging market with higher geopolitical salience than Argentina. Candidates include:

- Pakistan. Although Pakistan is facing a severe falloff in export earnings and a depressed GDP growth outlook -- while carrying a 43% debt/GDP load -- its status as a frontline state in the conflict in Afghanistan has won it important bilateral and multilateral concessions from the United States and the EU.

- Turkey. February's lira devaluation ended Turkey's IMF-sponsored inflation-stabilisation regime and set off a chain of banking sector problems and difficult structural reforms under IMF guidance and with regular Fund intervention. Along with Argentina, Turkey has been viewed as the most vulnerable emerging market crisis point. Its debt/GDP ratio of 80% exceeds Argentina's and, as with Argentina, its debt dynamic looks questionable. Turkey's status as a bridge between the western and Muslim worlds underlines the geopolitical imperative of maintaining commitments to its stability.

- Indonesia. The Fund is deeply involved in Indonesia's uneven recovery from the 1997 East Asia financial crisis. Indonesia's huge population, along with its status as the world's largest Muslim nation and geographical significance in oil and goods transport lanes, arguably put it, like Turkey, in a unique category. At the same time, the need for IMF involvement remains acute and the sustainabilty of Indonesia's economic policies is not beyond question. Its total debt approaches 90% of GDP.

Philippines and Brazil. The Fund's next engagement with a financial crisis could well come in a country with continual heavy reliance on external finance. The Philippines is conspicuous in this regard due to its continual difficulty in reducing the fiscal deficit, which it finances with both domestic and external bond issues. While the country's 70% debt/GDP ratio exceeds Argentina's, its flexible exchange-rate regime provides an advantage. Although the global economic downturn could inflict further stress on the Philippines, its currency regime neither requires defence (and thus commitment of precious reserves and subsequent loss of domestic liquidity) nor locks the domestic economy into an uncompetitive position vis-a-vis the international economy.

Despite the Philippines' apparent vulnerability, the IMF's post-Argentina limits could be tested first in Brazil, whose debt/GDP ratio is comparable to that of Argentina. While there are important differences between the two countries, markets are not likely to make a distinction between them should Argentina's debt resolution become chaotic.

New context. It can be argued that official intervention is even more important in Argentina's case than in previous ones since Argentina's crisis involves myriad participants in the international bond markets, rather than discrete numbers of banks. Debt resolution is far more problematic when there are too many agents to organise, partly due to individual incentive to intransigence in order to hold the outcome hostage to individual demands. This is why a 'global chapter 11' arrangement is often mooted to give Argentina and international negotiators the breathing space to work out the details of a restructuring. It may be that this is an appropriate role for the Fund since it straddles the private sector and sovereign borrowers.

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